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OIL PRICES

Stirring The Blends

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The following article was written for MEES by Liz Bossley, CEO of energy markets consultancy firm the Consilience Energy Advisory Group Ltd (CEAG).

Two issues are troubling the Brent market, but because of Brent's role in the international oil price formation process the ramifications reach two-thirds of world oil production and have a direct impact on Production-Sharing Contracts (PSA) around the world. These issues are as follows:

- With North Sea production declining, there is a lack of deal evidence to support the daily dated Brent assessments by the publications, even though Forties and Oseberg deals are included in the assessment process. *Platts* is undertaking an industry consultation to add Ekofisk to the dated Brent quotation; and,
- Forties Blend has suffered a sudden deterioration in quality following the start up of the 200,000 b/d medium sour Buzzard field in January 2007, which will form the majority of Forties Blend in the future. The quality of Forties has dropped to the point where it is now the grade of choice for delivery by sellers into the 21-Day BFO contract and Forties is now setting the price of that contract below the level that Brent and Oseberg could otherwise expect to command.

Any crude oil contract or PSA that has a Brent-based reference price is now, by definition, valued at the lower-valued Forties substitute grade rather than at the price of Brent Blend itself. This is because Forties is a contractual substitute for Brent in the 21-Day BFO contract and because the influential *Platts*-dated Brent quote is actually the lowest price of Brent, Forties and Oseberg deals done. Since Buzzard caused a significant deterioration in the quality of Forties it is now the price-determining grade. The problem will get worse over time as the proportion of Forties Blend that is Buzzard increases.

Remove Forties Blend?

According to a new study by CEAG, published last month, serious consideration should be given to the removal of Forties Blend as a deliverable grade from the 21-Day BFO contract and to its replacement by Ekofisk Blend for two reasons. The BFO price is extremely sensitive to Forties Blend, which in turn is sensitive to Buzzard production. The first effect of this, a structural and potentially permanent reduction in the price of BFO, is already in the market. The second, a potential volatility effect on price differentials in view of uncertain levels of Buzzard production, is yet to be felt and will depend on how the issues effecting Buzzard production are capable of being addressed.

The CEAG study addresses these issues and provides detailed data on forward production profiles out to 2012 to back it up. According to CEAG, under all foreseeable circumstances Ekofisk Blend should be added to the 21-Day BFO contract to bolster the volume available, partly to prevent a squeeze, but more importantly to increase the pool of cargoes traded to provide deal evidence for the reported price assessments on which a large proportion of the world's crude prices rely.

The removal of Forties Blend from the 21-Day BFO contract is by no means an ideal solution, says CEAG, as a 21-Day BOE contract without Forties has less than an optimum number of cargoes deliverable into the new contract. But, post-Buzzard, this is the new reality faced by the market. If Forties is replaced by Ekofisk in the 21-Day BFO contract and the dated Brent assessment, traders will have to remain on guard against squeezes. (See Table One)

A 21-Day BOE contract would not be dominated by any individual producer says CEAG. Even the combined shares of Statoil and Norsk Hydro, who are expected to merge later this year, would be only equivalent to the existing share of Total and there would be a sufficient spread of interests amongst a range of other producers to ensure a balanced market (see Chart 1).

New Forward Contract

The study introduces for consideration the prospect of a new forward contract constructed on the basis that, although Forties Blend may have to be removed from the 21-Day BFO contract, it may be suitable to form the basis of a medium sour marker in combination with Flotta and Urals Blends.

The market has been searching for a sour marker for a number of years and on several occasions has tried to shoehorn Russian Urals Blend into this role. Considerable quantities of crude oil, particularly in the Mediterranean and the Caspian are priced by reference to Urals. The New York Mercantile Exchange has an Urals futures contract, dubbed REBCO i.e. Russian Export Blend and ICE are actively considering the introduction of an Urals futures contract. But Urals does not sit easily in this role. Prices for Urals are quoted from the Black Sea ex-Novorossiysk, from the Baltic ex-Ventspils, Primorsk, Butinge or Gdansk, from the Barents Sea ex-Murmansk and CIF the Mediterranean port of Augusta to reflect the different ports from which it may be delivered.

Availability is uncertain with the northern ports being iced in during the winter. Availability in the Black Sea is also problematic given that vessels have to transit the Bosphorus and are frequently delayed at this bottleneck awaiting passage. These are significant drawbacks for any grade setting itself up as the basis of a forward or futures contract.

If the market wished to trade a 21-Day FF contract there would be almost 2 cargoes per day of FF in 2007 but less than 1 cargo per day by 2012. (See Table Two). Accepting Urals blend into the contract would be essential to ensure liquidity and to prevent squeezes.

Because of the price differentials between Forties, Flotta and Urals, Urals would be the grade delivered most often. If Urals was unavailable Flotta would be the next logical delivery choice and Forties would only be delivered under exceptional circumstances. However under certain Forties/Buzzard production scenarios Forties and Flotta could be almost identical in quality by 2012 making the two grades more logical substitutes. In the meantime the possibility of delivering Forties or Flotta would put a cap on prices if players attempted to squeeze the contract.

As shown in Chart 2, company interests in Forties and Flotta combined are spread widely out to 2012.

While market traders ponder the impact of Buzzard's addition to Forties Blend and consequently to the 21-Day BFO market and the *Platts*-dated Brent assessment, oil prices around the world have been written down by the new Forties discount to Brent. Yet most stakeholders remain unaware that any change has occurred.

Table 1
Cargoes Per Year

Year	BFO	BOE	BFOE
2007	887	748	1,266
2008	742	612	1,099
2009	634	562	975
2010	528	510	850
2011	451	463	745
2012	364	389	618

Table 2
Cargoes Per Year

	Forties	Flotta	Total
2007	518	67	585
2008	487	77	563
2009	412	60	472
2010	340	49	389
2011	282	42	324
2012	230	35	265

Chart 1

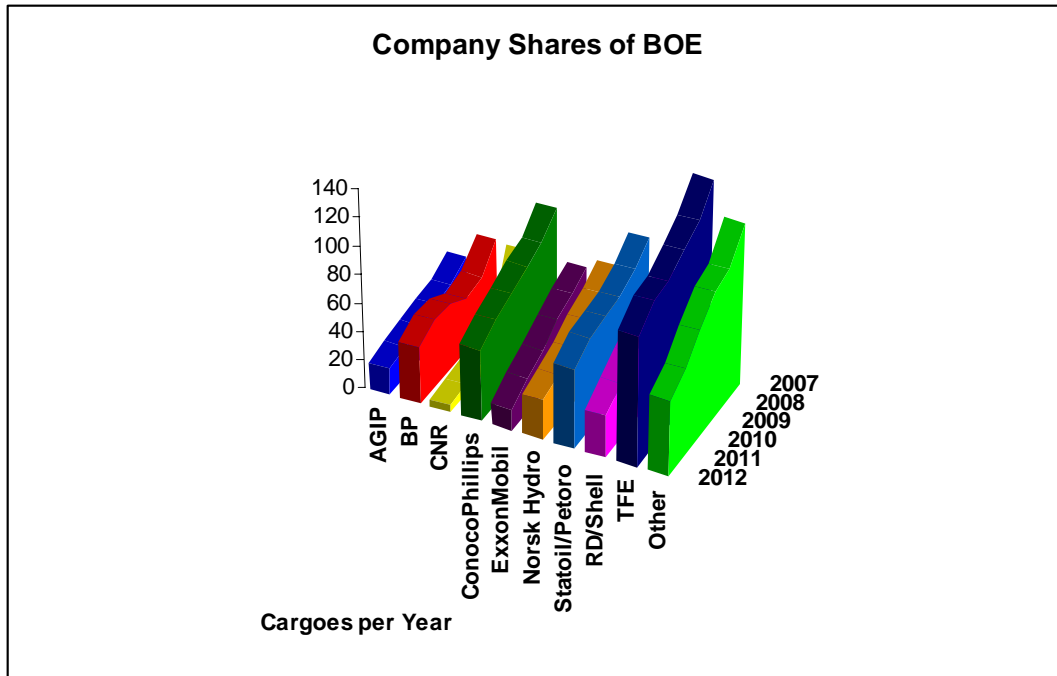


Chart 2

